Office of Chief Counsel
Internal Revenue Service

memorandum

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LRAverbeck

date: MAR 13 2002

to: [redacted]
Manager, Natural Resources and Construction Team [redacted]

from: Area Counsel
(Heavy Manufacturing and Transportation)

subject: [redacted]
Request for Advice
Allocations under § 338(h)(10) election

ISSUE

Whether the taxpayer's method of valuation and allocation of assets in a stock purchase transaction is proper under I.R.C. § 338(h)(10).

CONCLUSION

We support your conclusion that the taxpayer's method of valuation and allocation of assets in a stock purchase transaction is <u>not</u> proper under I.R.C. § 338(h)(10). The taxpayer's assertions that, in effect, contingent liabilities can be used indirectly at the time of the acquisition to decrease the gain on the deemed asset sale and that the contingent liabilities only burden certain classes of assets are legally and theoretically unsupported. The fair market value used for allocation purposes should more closely reflect the values of the assets determined using GAAP, as reported on the certified financial reports.

FACTS

[redacted]. In [redacted], [redacted] was purchased by [redacted], a publicly traded [redacted] company. In connection with the acquisition, [redacted] was formed as the U.S. company that acquired the stock of [redacted] from [redacted]. On its [redacted] return, the taxpayer elected to treat the stock purchase as an asset acquisition under section 338(h)(10), thereby obtaining a step-up in the basis of the assets of [redacted].[1]

After the acquisition, [redacted] was renamed [redacted] ("[redacted]"), and its stock became the principal asset of [redacted]. As part of its planning and implementation process, [redacted] engaged [redacted] to perform a valuation of the acquired company. [redacted] also separately valued [redacted]'s interests in joint ventures, its machinery and equipment, and its land and buildings.

As to the value of the company, using the discounted cash flow method, [redacted] concluded as follows regarding the value of the company:

> The discounted cash flow approach to the value of [redacted] is detailed in Exhibit 8. We estimate that the enterprise value of [redacted] is $[redacted]. Deducting [redacted]'s bank debt as of [redacted] from this amount results in a value of [redacted]'s equity of $[redacted]. Because this value approximates the tax-adjusted transaction value of [redacted]'s sale to [redacted], we accept this transaction value as the fair market value for [redacted], which equates to:
>
> $[redacted]

Likewise, employing an adjusted net book value approach and a capitalized income approach, [redacted] concluded that the value of the company's interests in joint ventures aggregated to $[redacted]. Utilizing a modified cash value approach and a market approach, the appraiser valued machinery and equipment and real property at $[redacted] and $[redacted], respectively. Values for current assets and liabilities were accepted at what [redacted] reported as their book value.

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[1] Because the acquisition occurred in [redacted], it is subject to "old" Treas. Reg. § 1.338(b)2T, which requires the allocation of the taxpayer's adjusted grossed up basis (AGUB) among five asset classes. Effective March 16, 2001, final regulations require the allocation among seven asset classes.

Generally, in developing its modified cash value of the machinery and equipment, [redacted] first determined the cost to replace each item with a new item. From such cost, an amount calculated to approximate depreciation and functional obsolescence was subtracted. Such methodology is, we believe, in accord with recognized valuation principles. **Up to this point in the valuation**, the Examination team, which includes two service engineers, generally agrees with the taxpayer's valuation of its assets.

However, at this point, an additional reduction was made for external or economic obsolescence (a diminution in value caused by certain extrinsic factors). [redacted] quantified this burden by first calculating the adjusted grossed up basis (AGUB) for purposes of section 338 and allocating it:

(1) to current assets at the values provided by [redacted];
(2) to interests in the joint ventures at their appraised value; and
(3) to non-depreciable real property at the properties' appraised value.

After those allocations, the difference between the replacement cost, less depreciation and functional obsolescence, for machines and equipment and real estate improvements and the remaining AGUB was **deemed** by [redacted] to be external or economic obsolescence. No separate calculation or analysis was prepared by [redacted] to support the value it ascribed to economic obsolescence. Moreover, embedded in the assignment of that burden to machines and equipment and real estate improvements is the unsubstantiated supposition that only those assets are burdened by the economic obsolescence. In terms of dollars, an external obsolescence charge of approximately $[redacted] was assigned to machines and equipment, resulting in the appraised value of $[redacted].

Based on the above, [redacted] generated a pro forma balance sheet that may be summarized as follows:

ASSETS		
Current assets		
Cash & Equiv.	$	[redacted]
A/R		[redacted]
Inv.		[redacted]
Cap. Fin. Costs		[redacted]
Total Current Assets		[redacted]
Interests in Jt. Ventures		
[redacted]		[redacted]
Total Ownership Interest in Jt. Ventures		[redacted]
Jt. Venture Rec. & Advances		[redacted]
Plant, Property & Equip.		
Land		[redacted]
Land Improvements		[redacted]
Buildings and Improvements		[redacted]
Machinery & Equipment		[redacted]
Total Plant, Property & Equip.		[redacted]
Deferred Charges		[redacted]
TOTAL ASSETS	$	[redacted]
LIABILITIES & SH EQUITY		
Current Liabilities		
A/P	$	[redacted]
Note Payable		[redacted]
Accrued Compensation		[redacted]
Accrued Interest		[redacted]
Accrued Taxes		[redacted]
Other Liabilities		[redacted]
Current Portion LT Debt		[redacted]
Total Current Liabilities		[redacted]
Long Term Debt		[redacted]
Deferred Credits		[redacted]
Total Liabilities		[redacted]
S/H Equity		[redacted]
TOTAL LAIBILITIES & S/H EQUITY	$	[redacted]

In considering the reasonableness of the allocations, it is insightful to recognize that in addition to being engaged to provide the valuation necessary for the section 338(h)(10) election, [redacted] also was engaged, on a contract basis, to operate [redacted]'s tax department, and to function as [redacted]'s auditor, certifying [redacted]'s financial statements. Significant here is that for GAAP reporting purposes, [redacted] certified the value of the assets of [redacted] for financial statement purposes as $[redacted], an amount approximately $[redacted] more than the value assigned to the same assets for purposes of the section 338(h)(10) election allocation.

The closing balance sheet for [redacted] showed a deficit in cash and cash equivalents, and no marketable securities. The preliminary valuation of the Class III assets - accounts receivable, inventories, machinery and equipment, depreciable real estate, land and interest in joint ventures - was substantially greater than the AGUB available for allocation. The excess of fair market value in Class III assets over AGUB would have required the taxpayer to report substantial gains.

The Exam team notes that the discounted cash flow analysis prepared by [redacted] for [redacted] takes into account the operating efficiencies of the plant by looking at future cash flows from the enterprise, and thus reflects any economic obsolescence that attached to the properties. This analysis supported the financial statement valuation of the assets. At the time of the acquisition, the taxpayer was subject to approximately $[redacted] in contingent liabilities, most of which represented the taxpayer's FASB 106 accrual for other post-retirement benefits. Consideration of those contingent liabilities caused the purchase price to be significantly below the total fair market value of the assets of the acquired company.

Based on the enterprise valuation, the exam team proposes using the final carrying amounts reflected in the taxpayer's financial accounting records as the best measurement of fair market value, and then making appropriate adjustments to reallocate AGUB on a pro rata basis across all of the taxpayer's Class III assets.

ANALYSIS

Section 338 of the Internal Revenue Code allows a corporation to elect to treat a stock purchase of a target corporation as a deemed asset acquisition. The target is treated as if it had sold all of its assets at the close of the acquisition date at fair market value. The "old" target corporation must then recognize taxable gain or loss as if it had sold its assets for their fair market value. The old target corporation will then be treated as a new corporation that purchased those same assets as of the beginning of the day after the acquisition date. The "new" target corporation gets a stepped-up basis in the assets.

The price at which the old target is deemed to have sold its assets is the aggregate deemed sales price (ADSP). ADSP is determined by taking the grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A)) plus the liabilities of the old target. Treas. Reg. § 1.338-4T(b).

The total amount for which the new target is deemed to have purchased all of its assets is the adjusted grossed up basis (AGUB). AGUB is the sum of the grossed-up basis in the purchasing corporation's recently purchased target stock, the purchasing corporation's basis in non-recently purchased target stock, and the liabilities of the new target, excluding contingent liabilities. Since AGUB is determined at the beginning of the day after the acquisition date, in order to be included in AGUB, an obligation must be a bona fide liability of target, as of that date, which is properly includible in basis under principles of tax law that would apply if new target had acquired old target's assets from an unrelated person and, as part of the transaction, had assumed or taken property subject to the obligation. General principles of tax law apply in determining the timing and amount of the elements of AGUB. Treas. Reg. § 1.338-5(b)(2)(i). New target receives a stepped-up tax basis in the assets deemed purchased from old target. AGUB is then allocated among new target's assets under a residual method to five asset classes, to establish the new basis of the assets. Treas. Reg. § 1.338(b)-2T. (The final regulations, which became effective on March 16, 2001, provide for an allocation among seven asset classes.)

Class I consists of cash and cash equivalents. Class II consists of certificates of deposit, government and other marketable securities, and foreign currency. Class III is a default classification for assets that do not fall into any of the other classes and also includes accounts receivable, inventory, plant, property and equipment. Class IV consists of amortizable section 197 intangibles other than goodwill and going concern value. Class V consists of section 197 intangibles in the nature of goodwill and going concern value.[2] AGUB is first allocated to Class I assets, then to Class II, Class III, and so on. Where the available AGUB exceeds the fair market value of the assets in any class, those assets obtain a fair market value basis. If the available AGUB is less than the aggregate fair market value of the assets in a class, the AGUB is allocated based on the respective fair market values of the assets in that class, until the AGUB is exhausted.

The amount of AGUB allocated to each asset cannot exceed the fair market value of that asset as of the beginning of the day after the acquisition date. For purposes of applying the residual method of allocation, fair market value is the gross fair market value *without regard to any associated liabilities*. Treas. Reg. § 1.338-6. It is the determination of fair market value for allocation purposes, that is at issue here.

Fair market value is usually defined as the price which would be paid for an asset on the open market, as between a willing buyer and a willing seller, neither of whom is obligated to enter into the transaction. The fair market value of an asset can equal the purchase price, if there is a simple transaction and the buyer does not assume any liabilities of the seller. Naturally, when an entire company is the thing being purchased, a buyer who is going to assume that company's liabilities would insist on a reduced price to account for the assumption of those liabilities. This reduced price might reflect the fair market value of the entire company, but could not represent the aggregate fair market value of the company's assets. When making allocations under section 338(h)(10), the fair market value of each individual asset is used.

At [redacted]'s request, [redacted] performed a valuation of [redacted]'s holdings at acquisition. [redacted] separately valued all of the assets, using generally accepted accounting principles, and included [redacted]'s debt to arrive at an overall fair market value for [redacted]. To ascertain the value of

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[2] The final regulations provided seven asset classes for the allocation from AGUB. Classes I and II remain substantially the same. Class III only consists of assets the taxpayer marks to market at least annually, and most debt instruments, including accounts receivable. Class IV includes inventory. Class V is the "catch-all" for assets not in the other classes. Class VI and Class VII correspond to the old classes IV and V, respectively. The effect of the seven class structure is to give debt instruments and accounts receivable a higher priority over inventory, and inventory a higher priority over "all other."

the machinery and equipment, [redacted] determined the cost of replacing each item with a new item, then subtracted the cost of depreciation and functional obsolescence. We believe that this method reflects the fair market value of the assets in question.

The taxpayer now claims that the total purchase price is equal to the total fair market value of all of the target's assets. The taxpayer further asserts that the difference between the aggregate fair market value of the assets and AGUB represents external obsolescence and should be allocated only to plant, property and equipment. Both of these assertions are unsupportable.

When the acquiring corporation assumes, pursuant to the purchase contract, accrued liabilities of the target corporation, these liabilities are treated as a cost of acquisition and therefore, must be capitalized. Contingent liabilities do not initially qualify for inclusion in AGUB. The acquiring corporation makes an upward adjustment in the basis of its assets in the amount of the contingent liabilities at the time the contingent liabilities become fixed and determinable. Temp. Reg. § 1.338(b)-1T(f).

The taxpayer is incorrect in its assertions that the contingent liabilities can be used at the time of the acquisition to decrease the gain on the deemed asset sale and that the contingent liabilities only burden certain classes of assets. The regulations and case law clearly allow an adjustment for the assumption of contingent liabilities only when those liabilities become fixed and determinable. See Magruder v. Supple, 316 U.S. 394 (1941); David P. Webb Co., Inc. v. Commissioner, 708 F.2d 1254 (7th Cir. 1983); Rev. Rul. 76-520. In addition, the regulations and case law do not provide any authority for the taxpayer's attempt to burden only certain asset classes with the assumption of contingent liabilities. Nor is there any authority in the regulations governing section 338(h)(10) for a further reduction based on "external obsolescence."

We therefore support the examination team's proposal to use the final carrying amounts reflected in the taxpayer's financial accounting records as the best measurement of fair market value, and then make appropriate adjustments to reallocate AGUB on a pro rata basis across all of the taxpayer's Class III assets.

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By:______________________________
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